

Yen 4Sight

Highlights

- The latest Reuters Tankan suggested that Japan's economy maintained a steady upward trend at the start of 2017.
- Manufacturing output remains firm, while spending by overseas visitors likely provided further support to GDP growth in Q416.
- The coming week will bring November's all-industry activity figures (Monday), as well as December's goods trade report (Wednesday) and CPI data (Friday).

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Interest and exchange rate forecasts

| End period | 20-Jan | Q117 | Q217 | Q317 |
|------------|--------|-------|-------|-------|
| BoJ ONR % | -0.10 | -0.10 | -0.10 | -0.10 |
| 10Y JGB % | 0.07 | 0.05 | 0.05 | 0.05 |
| JPY/USD | 115 | 118 | 120 | 122 |
| JPY/EUR | 123 | 120 | 120 | 120 |

Source: Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

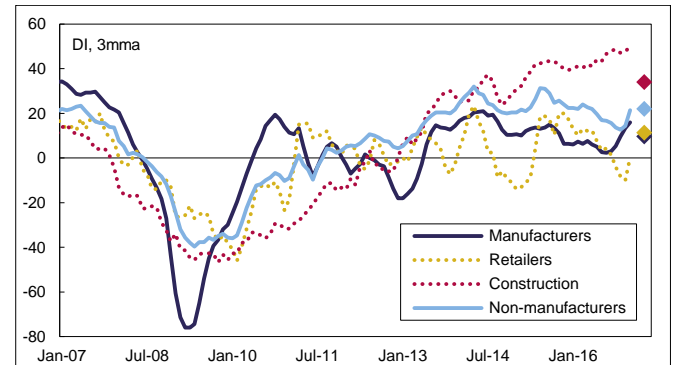
Positive momentum maintained in early 2017

While Japan's economy likely chalked up a fourth consecutive quarterly expansion in Q416, surveys suggest that positive momentum was maintained at the start of 2017 too. Certainly, the BoJ's Regional Economic Report upwardly revised the assessment of conditions in three regions on the back of firmer private consumption. And in all nine regions the economy is now judged to have been recovering over the past three months. Likewise, the latest Reuters Tankan provided a sanguine assessment of business conditions in January. This was certainly true of non-manufacturers, with the relevant diffusion index (DI) rising 11pts on the month to +30, a nineteen-month high. Retailers and construction firms alike were more upbeat, with the relevant DIs at twelve-month and series highs respectively, and non-manufacturers also broadly expect conditions to remain advantageous over the coming three months. Similarly, manufacturers signalled conditions to be the most favourable for more than two years – the relevant DI rose 2pts to +18 – not least thanks to yen depreciation and improved external demand. And they expect conditions to be supportive of growth through to April too. So, if this survey is to be believed, GDP should maintain a positive upward trend in the first quarter of 2017.

Machine orders data provide mixed messages

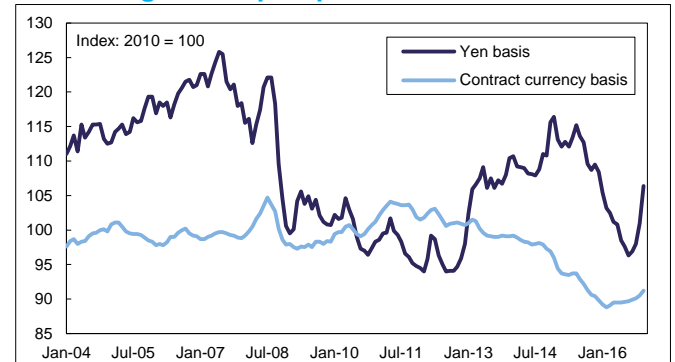
Despite the seemingly more favourable conditions and evidence suggesting that exporters are taking advantage of the weaker currency to boost profit margins, the extent to which private sector fixed investment will support economic growth over the near term remains unclear. Certainly, the past week's machine orders data – which provide a guide to capex growth three months ahead – were disappointing, with core orders declining 5.1%/M/M reverse the increase in October. The drop more than fully reflected a decline in orders placed by non-manufacturers, while orders placed by manufacturers rose for the first month in four. Of course, the machine orders figures are typically highly volatile and it remains to be seen whether orders will contract over the fourth quarter as a whole. Moreover, the still-elevated backlog of unfinished orders suggests some support to fixed investment ahead. In addition, a further notable gain in overseas machinery orders in November might also foreshadow ongoing recovery in exports of capital goods over the near term.

Reuters Tankan: Business conditions*



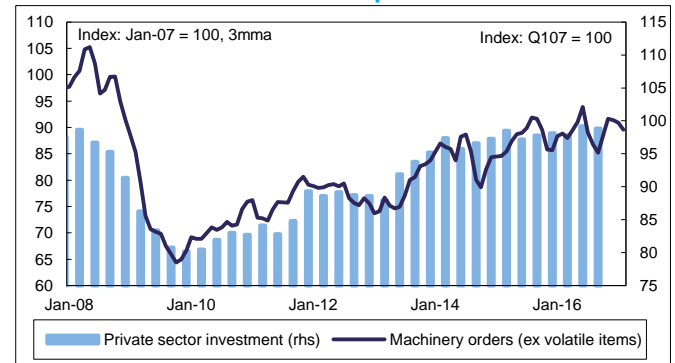
*Large firms. Diamonds represent survey forecast for April 2017. Source: Reuters Tankan and Daiwa Capital Markets Europe Ltd.

Producer goods export prices



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Private sector orders and capex*



*Orders data have three-month lead. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.



Manufacturing output on the up

The improved external environment has already provided a shot in the arm for the manufacturing sector over recent months. Revised data in the past week confirmed that manufacturing output rose 1½%M/M in November to leave it up more than 4½%Y/Y. And the notable increase in production of capital goods, which rose to its highest level since the start of 2015 to leave it up almost 4%3M/3M, should bode well for the investment outlook too. Conditions also appear in place for further near-term gains in production. Indeed, given a slightly stronger than initially thought increase in shipments and a larger decline in inventories, the inventory-shipment ratio fell by 5½%M/M in November to its lowest level since April 2014. So, taken together with recent sentiment surveys, manufacturing looks set to have provided non-negligible support to the economic recovery at the turn of the year.

Tertiary activity trending broadly sideways

In contrast, November's figures for tertiary activity – which accounts for more than two-thirds of overall output – were, at face value, disappointing, with output trending broadly sideways. But this still left it up more than 1%Y/Y, the fastest such pace for a year. And a good deal of the weakness in the latest month was associated with a statistical anomaly related to seasonality of sporting events. Indeed, in the absence of that effect, tertiary activity would have risen by ½%M/M, supported in no small part by increased activity in the hospitality sector thanks to the rising number of foreign visitors. Indeed, as well as a further jump in output from the hotel sector in November, restaurant and tourism services rose to their highest levels in a year.

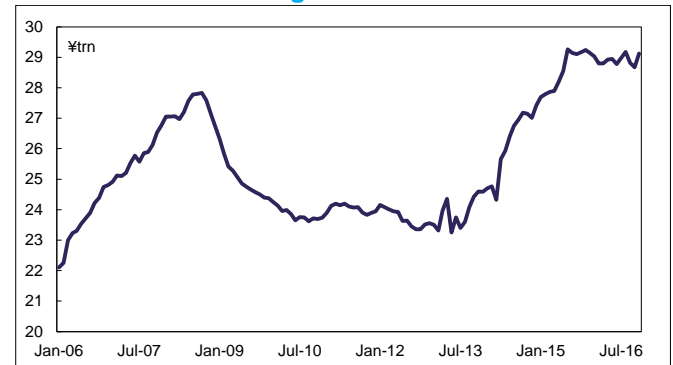
Spending by foreign visitors remains firm

The rising contribution to growth from the hospitality sector is hardly surprising given the steady rise in overseas visitors last year, with spending by tourists continuing to offer support to GDP growth. Admittedly, the average spend per visitor continued to drift lower at the end of 2016 to the lowest since Q214 and down more than 12%Y/Y, principally reflecting less spending per visitor from China. But although individual tourists might on average be spending less, the total number of foreign visitors once again exceeded 2mn in December for the sixth month in 2016, taking the total over the fourth quarter as a whole to more than 6mn, up more than 15% from the equivalent period in 2015. So, overall, their total spend in Q4 was up more than 1%Y/Y at ¥892bn, with double-digit annual growth in spending by visitors from Korea and the US. And over the year as a whole the total spend by tourists stood at a record ¥3.7trn, almost 8% higher than in 2015.

Pipeline price pressures step up at end-2016

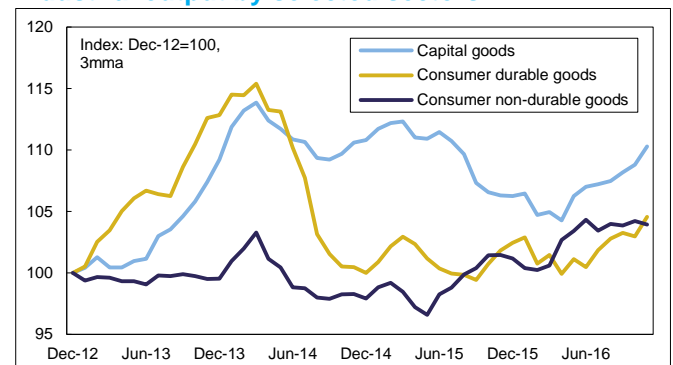
While the weaker yen should, in principal, support Japanese exporters of services and goods alike, it should also in due course provide an impulse to inflation. December's corporate goods price index showed a pickup in pipeline pressures at the end of last year with producer prices rising 0.6%M/M – the most since the consumption tax hike in 2014 – to leave the year-on-year rate of decline easing considerably to just -1.2%Y/Y, the smallest drop for two years. While this principally reflected higher prices of petroleum, there was also a significant upward shift in prices of other imported items. So,

Machine order backlogs



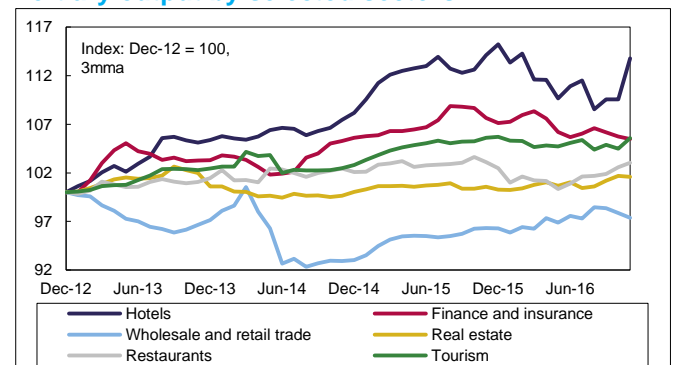
Source: Cabinet office and Daiwa Capital Markets Europe Ltd.

Industrial output by selected sectors



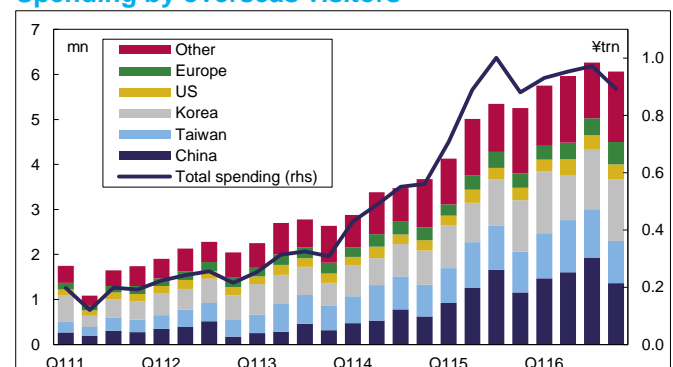
Source: METI and Daiwa Capital Markets Europe Ltd.

Tertiary output by selected sectors



Source: METI and Daiwa Capital Markets Europe Ltd.

Spending by overseas visitors



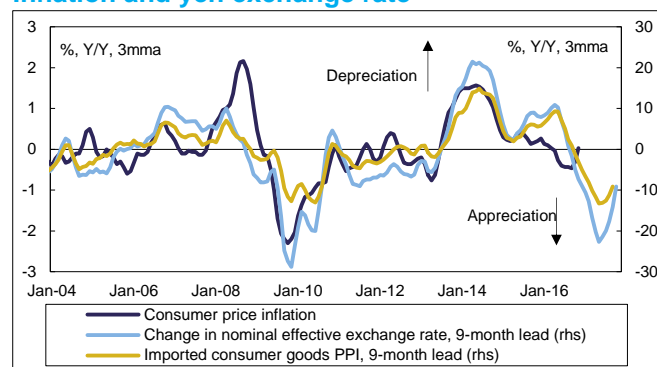
Source: JTNO, JTA and Daiwa Capital Markets Europe Ltd.

in yen terms, the pace of decline of import prices moderated by more than 7ppts to -2.8%Y/Y. There was also a surge in prices of imported final consumer goods, up more than 4%M/M, the largest since 1979. But with domestic price pressures still relatively subdued amid ongoing weak wage growth, overall consumer goods prices were still down more than 1½%Y/Y, signalling a good deal of persisting downward pressure in the CPI pipeline too. And while we would expect to see various inflation measures establish a clear upward trend through the first half of the year, pressures seem set to remain insufficient to push headline CPI anywhere near the BoJ's 2% target for several quarters to come.

The week ahead in Japan and the US

The coming week in Japan brings a number of top-tier releases, kicking off on Monday with November's all-industry activity data. Given the increase in tertiary and industrial output that month, as well as an anticipated improvement in construction activity, total output is expected to have risen by ½%M/M. Ongoing improvement in the manufacturing sector in early 2017 looks set to be the message from January's flash manufacturing PMI on Tuesday, while December's goods trade report is likely to signal that net trade provided a notable positive contribution to GDP growth in Q4. The data focus at the back end of the week will turn to inflation with the latest CPI figures due on Friday. Not least given a likely moderation in inflation of fresh food prices in December, headline CPI is expected to have fallen from the eighteen-month high of 0.5%Y/Y in November. But underlying price pressures are expected to have remained subdued too, with the BoJ's new preferred rate of core CPI (excluding fresh foods and energy) forecast to fall to a new post-QQE low of 0.1%Y/Y. In the JGB market, a 40Y JGB auction will be conducted on Tuesday.

Inflation and yen exchange rate



Source: BoJ, MIC, BIS, Bloomberg and Daiwa Capital Markets Europe Ltd.

In the US, it will be busy end to the coming week for top-tier data, with most notably the first estimate of Q4 GDP on Friday expected to show that growth slowed in the final quarter of 2016 as some temporary factors which flattered growth in Q3 reversed. Indeed, expectations are for annualised growth of around 2%Q/Q down from a rate of 3½%Q/Q in Q3 but broadly in line with the average of the previous two years. Friday will also bring December's preliminary durable goods figures, which will be preceded on Thursday by the advance goods trade report and wholesale inventories data. Various housing market indicators are also due throughout the week, including existing home sales (Tuesday), the FHFA home price index (Wednesday) and new home sales figures (Thursday). But, all eyes, of course, will be on the first policy actions of President Trump. Supply-wise, the US Treasury will sell 2Y notes on Tuesday, 2Y floating-rate notes and 5Y notes on Wednesday and 7Y notes on Thursday.

Economic calendar

Key data releases – January/February

| 16 | 17 | 18 | 19 | 20 |
|--|--|--|---|---|
| MACHINE ORDERS M/M% OCT 4.1 NOV -5.1 TERTIARY ACTIVITY M/M% OCT 0.0 NOV 0.2 GOODS PPI Y/Y% NOV -2.2 DEC -1.2 BOJ REGIONAL ECONOMIC REPORT | 20Y JGB AUCTION INDUSTRIAL PRODUCTION M/M% OCT 0.0 NOV F 1.5 CAPACITY UTILISATION M/M% OCT 1.4 NOV 3.0 | 1Y TB AUCTION OVERSEAS VISITORS MN NOV 1.9 DEC 2.1 | 3M TB AUCTION 5Y JGB AUCTION | REUTERS TANKAN – MANUFACTURING DI DEC 16 JAN 18 NON-MANUFACTURING DI DEC 19 JAN 30 DEPARTMENT STORE SALES NOV -2.4 DEC -1.7 |
| 23 | 24 | 25 | 26 | 27 |
| ALL INDUSTRY ACTIVITY M/M% OCT 0.2 NOV 0.5 SENIOR LOAN OFFICER SURVEY (JAN) | 40Y JGB AUCTION (APPROX ¥0.5TRN) MANUFACTURING PMI DEC 52.4 JAN P N/A | GOODS TRADE BALANCE ¥BN NOV 536 DEC 276 | 3M TB AUCTION (APPROX ¥4.4TRN) AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.5TRN) SERVICES PPI Y/Y% NOV 0.3 DEC N/A | NATIONAL CPI Y/Y% NOV DEC 0.5 0.3 EX FRESH FOOD -0.4 -0.3 EX FOOD/ENERGY 0.2 -0.1 EX FRESH FOOD/ENERGY 0.2 0.1 TOKYO CPI Y/Y% DEC JAN 0.0 0.0 EX FRESH FOOD -0.6 -0.4 EX FOOD/ENERGY -0.2 -0.1 |
| 30 | 31 | 01 | 02 | 03 |
| 2Y JGB AUCTION RETAIL SALES (DEC) BOJ POLICY BOARD MEETING (30-31 JANUARY 2017) | INDUSTRIAL PRODUCTION (DEC) UEMPLOYMENT RATE (DEC) JOB-TO-APPLICANT RATIO (DEC) HOUSEHOLD SPENDING (DEC) CONSTRUCTION ORDERS (DEC) HOUSING STARTS (DEC) BOJ POLICY BOARD ANNOUNCEMENT AND OUTLOOK REPORT | MANUFACTURING PMI (JAN F) | 3M TB AUCTION 10Y JGB AUCTION CONSUMER CONFIDENCE (JAN) BANKRUPTCIES (JAN) MONETARY BASE (JAN) | SERVICES PMI (DEC) COMPOSITE PMI (DEC) |
| 06 | 07 | 08 | 09 | 10 |
| AVERAGE WAGES (DEC) | 10Y INDEX-LINKED JGB AUCTION | 6M TB AUCTION ECONOMY WATCHERS SURVEY (JAN) BANK LENDING (JAN) CURRENT ACCOUNT (DEC) | 3M TB AUCTION 30Y JGB AUCTION MACHINE ORDERS (DEC) HOUSING LOANS (Q4) | TERTIARY ACTIVITY (DEC) GOODS PPI (JAN) |

Source: BoJ, MoF, Bloomberg & Daiwa Capital Markets Europe Ltd.

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